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No. 839

IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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REPLY BRIEF FOR THE PETITIONER

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CITATIONS

CASES: Page

Casey v. *Commissioner*, 276 F. 2d 26, 3 AFTR 2d 1440 (CA 2, 1959) 2, 4, 7

Helvering v. *National Grocery Co.*, 304 U.S. 282, 291, 82 L. Ed. 1346, 1354 ..... 1, 6, 7

Knoxville v. *Knoxville Water Co.*, 212 U.S. 1, 13, 53 L. Ed. 371, 380 ..... 1, 6, 7

MISCELLANEOUS:

Mertens, *Law of Federal Income Taxation*, Section 39.46 7

1960 Prentice-Hall Federal Tax Service, p. 4718 7

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REPLY BRIEF FOR THE PETITIONER

Omissions from respondent's brief in opposition are of controlling significance, as follows:

1. It does not deny that the decision below is in direct conflict with the decisions of this Court in *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 291, 82 L. Ed. 1346, 1354, *Knoxville* v. *Knoxville Water Co.*, 212 U.S. 1, 13, 53 L. Ed. 371, 380 and all other authorities unanimously holding that a business corporation is entitled to accumulate

earnings for replacement of depreciated and depleted operating assets.

2. It does not deny that the decision below is in direct conflict with the Second Circuit's decision in *Casey* v. *Commissioner*, 276 F. 2d. 26, 3 AFTR 2d 1440 (CA 2, 1959) holding (a) that the burden of proof should have been upon respondent and (b) that the test of reasonable needs is dependent upon the corporation's honest belief during the period involved rather than upon what may appear to others to have been reasonable on the basis of "second-guessing" hindsight many years later.

3. It does not deny that petitioner began business in 1927 with assets of more than $7,365,179.85 and had assets of only $7,003,917.83 at the end of 1945. It does not deny that during the 1945-1950 period petitioner's assets were not equal to the assets with which it began business in 1927 until 1947, even though its earnings were retained and substantially expended for tugs, barges and other business needs.

4. It does not deny that all retained earnings during petitioner's *entire existence* not expended in carrying on its business were *at all times* insufficient to pay its liabilities, as specifically found by the Tax Court, in 1945-1950.

5. It does not deny that due to inflation in the 1945-1950 period petitioner was approximately $2,000,000.00 worse off economically at the end of 1950 than at the beginning of 1945.

6. It does not deny that in determining reasonable business needs the Court of Appeals (a) refused to take into account either the prevailing prices ($4,366,489.38 to $6,700,733.16) of the 1945-1950 period required to replace admittedly exhausted operating assets or the stipulated replacement reserves ($2,041,378.29 to $2,358,419.03) based upon low prewar costs and (b) refused to take into account

income tax liabilities of $1,794,562.00. It does not deny that had petitioner's right to replace its exhausted assets been recognized on either basis and its income tax liability taken into account, the Court of Appeals would necessarily have held that petitioner suffered heavy accumulated earnings *deficits* during the entire 1945-1950 period.

7. It does not deny the accuracy of this statement at page 22 of the petition for certiorari:

> "It is solely by ignoring the specifically found replacement needs based on low prewar cost and the specifically found income tax liabilities that either Court below could reach the clearly erroneous crucial holding that petitioner had accumulated earnings beyond the reasonable needs of its business."

8. It does not deny that throughout two lengthy trials respondent called no witness to testify that petitioner had accumulated earnings beyond the reasonable needs of its business, even though it is clear (a) that petitioner's case was never considered on the merits by the Secretary or his delegate and (b) that deficiency notices were sent without being read by any official authorized to determine deficiencies.

9. It does not deny the accuracy of this statement at page 7 of the petition for certiorari:

> "When liquid assets only are taken into account, the reasonable business needs, as found by the Tax Court, including the necessity for replacing exhausted property, show that the 1945-1950 *deficits* in liquid assets on the Tax Court's own basis, ranged from $5,195,805.09 to $7,889,952.15."

10. It does not deny that on the basis of *undisputed* documentary proof and *unimpeached* testimony of ten of the ablest witnesses in the country, petitioner's total assets compared with its conclusively established reasonable needs as follows:

Year	Total Assets	Proven Reasonable Needs	Accumulated Earnings Deficits
1945	$7,003,917.83	$18,280,259.49	$(11,276,341.66)
1946	7,240,879.10	20,422,503.59	(13,181,624.49)
1947	7,624,693.11	23,347,239.63	(15,722,546.52)
1948	7,858,778.29	25,066,718.68	(17,207,940.39)
1949	7,880,412.59	24,203,644.03	(16,323,231.44)
1950	8,271,879.53	25,291,480.04	(17,019,600.51)

11. It does not deny that in direct violation of the August 11, 1955 amendment to Section 534 of the Internal Revenue Code of 1954, petitioner has been deprived of its *statutory right* to have its case (a) considered on the merits by the Secretary of the Treasury or his delegate and (b) tried and decided by the Tax Court with the burden of proof on respondent. *Casey* v. *Commissioner, supra.*

Misstatements in respondent's brief in opposition are also of controlling significance, as follows:

12. The brief (p. 6) states:

> "In determining the ultimate factual question whether the taxpayer was accumulating its earnings or profits beyond the reasonable needs of its business, the Tax Court accepted, for each year, the figure for surplus, consisting of surplus not earmarked and reserves shown on the books, taken from the stipulated balance sheets of the company (Pet. 38a-39a), and subtracted therefrom the 'Reserves accepted as reasonable,' plus 'Loans to customers,' and $500,000 for working capital."

This statement is incorrect. What the Tax Court did was to *find as a fact* that petitioner's reserves and liabilities ranged from $7,813,657.96 to $9,516,556.[illegible] in 1945-1950, including its reserves for depreciation, depletion, bad debts, and income tax liability ranging from $2,898,337.12 to $4,276,070.98. The Tax Court also *found as a fact* that petitioner's total assets ranged from only $7,003,917.83 to

$8,271,879.53 in 1945-1950. However, in its opinion it reached the conclusion of unreasonable accumulation by *entirely omitting* the $2,898,337.12 to $4,276,070.98 of specifically found income tax liability and reserves for depreciation, depletion and bad debts. Had this erroneous omission not been made it is perfectly clear, *with mathematical certainty*, that both the Tax Court and the Court of Appeals would necessarily have held that petitioner was in a heavy *deficit* position during the entire 1945-1950 period (Transcript Vol. I, 19-28).

13. The brief (p. 7) states:

> "In its second appeal to the Court of Appeals, the taxpayer argued that, in addition to the reserves of $1,333,000 for postwar rehabilitation and $100,000 for sand and gravel replacement, as set out on its books (Pet. 39a), it should also be entitled to deduct amounts covering depreciation, depletion, and bad debts."

This statement is incorrect and misleading. Petitioner has never argued that its inadequate reserve of $1,333,000 to cover extraordinary *repairs* bears any relation to, or has any connection with, the separate and distinct reserves on its balance sheet for *replacement* of assets lost through depreciation, depletion, and bad debts. The fact is, as found by the Tax Court, the actual amount required and expended for repairs was "approximately $3,811,600" (Vol. I, 6a, 25a). It is clearly erroneous to confuse *necessity for repairs* with *necessity for replacements*. The allowance of a reserve for repairs is clearly no answer to the serious error below whereby petitioner has been deprived of any right to reserves for replacement of assets lost through depreciation and depletion. Yet, the opposition brief is permeated with an attempt to have the reserve for repairs treated as a reserve for replacement. This is done despite the fact that the record establishes that the repair and replacement reserves are wholly unrelated.

14. In stating (Br. p. 7) that the Court of Appeals rejected petitioner's contention that it was entitled to have its bad debts, depreciation and depletion replacement reserves taken into account in determining reasonable needs, the opposition brief fails to point out that this holding was based *solely upon a newly enunciated rule of law to the effect that consideration of established replacement needs would constitute giving taxpayers the benefit of unallowable "double deductions"*. As shown by the affidavit of a Certified Public Accountant (Pet. 14-15) such holding is not in keeping with accounting principles and *undeniably* is in direct conflict with *Helvering* v. *National Grocery Co.*, *supra*, *Knoxville* v. *Knoxville Water Co.*, *supra*, and all other authorities.

15. Petitioner's contention is incorrectly stated at page 9 of the opposition brief. Petitioner's contention is that the opinions below are in direct conflict with the facts as specifically found below. It is perfectly clear that the Tax Court specifically found as a fact that petitioner's replacement reserves and income tax liability ranged from $2,898,337.12 to $4,276,070.98 in 1945-1950 and then completely overlooked, *without any explanation for so doing*, these specifically found reserves and liabilities in determining petitioner's reasonable business needs. The Court of Appeals has approved this unexplained oversight on the part of the Tax Court. Petitioner's position is that in so doing the Court of Appeals is in direct conflict with the decisions of this Court and all other authorities.

16. The alleged mathematical error referred to at page 12 of the opposition brief does not exist and never has existed. The Tax Court specifically found, itemized and tabulated the tax liabilities (Vol. I, 31a) and there is no basis for suggesting that a mathematical error exists with respect thereto (Vol. III, Petition for Rehearing, pp. 14-15).

17. Contrary to the statement at page 10 of the opposition brief, the Court of Appeals did recognize that peti-

tioner's officers sincerely and honestly believed that it was in imminent danger of being forced into the ready-mixed concrete business in 1945-1950, but held that such sincere and honest belief was not the test. The Court of Appeals' position was made clear on this point during oral argument. The Second Circuit's "honest belief" test enunciated in *Casey* v. *Commissioner*, *supra*, was dismissed as "just the Second Circuit's opinion." The Court made it clear that it would not follow the "honest belief" test but would apply the second-guessing hindsight reasonableness test as set forth in its opinion. *The direct conflict between the Second Circuit and the Fourth Circuit on this point is so glaring that respondent's brief neither discusses nor cites Casey* v. *Commissioner*, *supra*.

18. **It is of controlling importance to note:** From beginning to end the opposition brief does not mention, or make any attempt to defend or justify, the erroneous "double deduction" theory on the basis of which the Court of Appeals has refused to allow petitioner to accumulate any earnings to replace its admittedly exhausted operating facilities at either their low prewar cost or the inflated cost prevailing in 1945-1950. This newly stated "double deduction" theory is manifestly unsound and is in direct conflict with and complete disregard of the opinions of this Court and all other authorities. *Helvering* v. *National Grocery Co.*, *supra*, *Knoxville* v. *Knoxville Water Co.*, *supra*, Mertens, *Law of Federal Income Taxation*, Section 39.46, 1960 Prentice-Hall Federal Tax Service, p. 4718.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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